IN THE CIRCUIT COURT
THIRD JUDICIAL CIRCUIT
MADISON COUNTY, ILLINOIS

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In the Matter of Charles Sparks, *et al.* v. Lucent Technologies Inc., *et al.*	Cause No. 96-LM-983

Testimony Report

I. Qualifications and Work History

My qualifications and work experience are attached as Appendix A.

II. Description of Materials Reviewed

Attached as Appendix B is a list of all cases, orders, and other documents I have reviewed in preparing to testify in this case. Supporting documents follow this list and are included in Appendix B.

III. Description and Summary of Testimony

A. Description of Testimony

I have examined and reviewed the documents relevant to this case in order to provide an opinion regarding whether the actions of AT&T Corp., and later Lucent Technologies, Inc., regarding the leasing and sale of customer premises equipment (CPE) complied with the requirements of the Federal Communications

Commission ("the FCC") and whether the actions of AT&T and Lucent that were not required or mandated by the FCC were consistent with the FCC's requirements and orders.

I have also considered the assertions and conclusions reached by the plaintiffs' experts, Charlotte TerKeurst, Barbara Alexander, and Henry Rivera. Moreover, I have considered a number of suggested courses of action that AT&T and Lucent should have followed during the period of 1986-2000, as well as certain relief that plaintiffs have proposed in this case. I will provide an opinion on whether those assertions and proposals for relief would be consistent with the spirit and letter of the FCC's orders regarding CPE deregulation.

B. Summary of Testimony

As a result of my personal involvement and familiarity with CPE deregulation, refreshed by my review of relevant documents, orders, and cases regarding the issues presented in this case, I have concluded that the actions of AT&T, and later Lucent, were in accordance with all legal requirements and were consistent with the FCC's expectations and desires in deregulating the residential CPE market. AT&T's actions, moreover, were for some time monitored for compliance by the FCC itself. And in fact, not only were AT&T's actions compliant and consistent with FCC rules and goals, they were necessary to achieve the significant benefits that have, in fact, followed from the deregulation plan mandated by the FCC.

In addition, I have concluded that the analyses of the plaintiffs' experts appear not to be based on—or choose to ignore—the circumstances present at the time of CPE deregulation, the legal requirements, policy considerations and political realities that applied to the FCC's actions at that time, or a full understanding of the FCC's actions themselves. Therefore, I disagree with the plaintiffs' experts' opinions and conclusions on the following issues:

- Whether the sale and lease of residential CPE constitutes a single market;
- What measures were necessary to protect ratepayers under the *Democratic Central Committee* doctrine and the public industry standard;
- The lawfulness and legal necessity of certain AT&T actions in implementing the detariffing of embedded CPE;
- What the legal and policy bases were for the FCC's CPE "Price Protection Plan"; and
- The legality or wisdom of attempting to exert direct or indirect price controls on AT&T after the end of the period indicated by the Price Protection Plan.

Finally, I conclude that AT&T's actions, which are the subject of this lawsuit, clearly could have been anticipated by regulators and the marketplace, were in fact anticipated, and were lawful and appropriate. Moreover, both the prayer for relief and the measures that the plaintiffs and their experts insist should have been in place add up to nothing more than an unwarranted attempt to retroactively re-regulate the CPE marketplace. Such measures are inconsistent with, and would

violate, both the letter and spirit of the FCC's rules and orders, which h
effect of pre-empting any state, local, or federal attempts to apply such special
regulatory treatment to AT&T's provision of residential CPE. A continuing regulation of AT&T's residential CPE would have had the effect of benefiting a narrow subset of CPE customers, at the expense of ratepayers in general. A retroactive "re-regulation" of this offering would totally contradict the basis for the CPE deregulation itself. This would also have the effect of limiting the ability of regulatory agencies in the future to expeditiously craft and implement innovative initiatives.

IV. The Global Environment for Deregulation of CPE

A. From Monopoly to Competition

For most of the Twentieth Century, the provision of telephony was regarded as a natural monopoly and was provided as a utility service, similar to the provision of water, electricity or natural gas. In most of the countries around the world, telecommunications was nationalized or otherwise provided by a government agency or government-owned entity. In the United States, telecommunications remained a private sector activity, but in most areas of the country local telephony was provided by a single company—a regulated monopoly. One of those monopoly providers, the Bell System, provided local telephony in a majority of areas around the country and to a majority of its residents, as well as providing toll services throughout the United States, under the watchful eye of the FCC.

During this period in the United States, which lasted until the 1970s, c leased CPE from their telephone service providers, including the Bell telephone companies. Beginning in the 1950s, however, commercial pressure grew to allow the competitive provision of CPE—initially in the business market, but then, increasingly, in the residential market, as well. The FCC gradually embraced the idea of competition, actively accommodating and encouraging it by the 1970s. As a result, a vibrant, competitive market for CPE began to develop, led by the marketing of specialized business CPE and computers. The FCC also foresaw, and began to plan for, the growth and deregulation of a competitive residential CPE market, which had been presaged by the *Hush-a-Phone* and *Carterphone* decisions. Essentially, these market trends, and the FCC's response to them, eroded and then erased the previous policy and regulatory consensus in the United States that CPE should be provided as part of a monopoly utility.

State regulators, however, did not embrace the movement toward competitive provision of CPE, and in fact often opposed or tried to undermine it—acting pursuant to the best of motives. State regulators were concerned about the possible effect that CPE deregulation would have on residential service prices. At that time (and perhaps even now), residential telephone services were under-priced in relation to market demand and costs, particularly in rural areas. This held true for residential CPE prices, as well (including maintenance prices), which were seen as part of a consumer's access to basic telephone services. This meant that prices were held artificially low for unbundled CPE, and through the fact of

bundling CPE with local service, itself. State regulators sought to keep CPE prices low, motivated by the desire to maintain low-cost access to basic telecommunications, particularly in rural areas and to avoid political embarrassment or harm.

It may be understandable for regulators to seek low prices, whether those prices are economically justifiable or not. But clearly, if the price for a product is held artificially below its market price, competition simply cannot develop for that product. There will be no incentive for competitors to enter the market for delivering that product, because competitors will have no ability to price their alternative, rival products at a competitive, attractive level to gain customers. The state regulators' emphasis on maintaining artificially below-market rates, while motivated by honestly held policy goals and rationales, was directly at odds with the FCC's recognition of, and desire to accelerate, the growth of a competitive market for residential CPE.

B. The FCC Clearly and Correctly Saw Sale and Lease of Residential CPE as a Single Market

Many of the views and arguments put forward by the plaintiffs' experts appear to rely upon the claim that AT&T employed market power in what they call the "residential CPE leasing market." They claim that AT&T, and later Lucent, did not do enough to inform their embedded-base lease customers of their CPE options, which included the ability to buy their own CPE. These experts appear to believe that AT&T and Lucent misled their customers in order to perpetuate some

kind of market power in a separate leased CPE market for residential customers. This view can only be valid, however, if they deny that the retail CPE available to residential customers for purchase at that time (and ever since) was fully substitutable for the leased CPE that constituted the embedded base.

The plaintiffs' experts' reports are permeated with an internal contradiction. They simultaneously argue that the failure to "assist" customers in substituting purchased CPE for leased CPE was improper because purchased CPE was a totally acceptable substitute, while also maintaining that AT&T enjoyed market power in a separate leased CPE market.

The FCC recognized—and stated repeatedly and explicitly—that, with regard to residential customers, sold CPE was fully substitutable for leased CPE—that the two constituted a single market for residential equipment. For example, the FCC states in its 1983 CPE implementation order the following:

> Further, we return to our earlier conclusion that the competitive marketplace offers ready relief to those residential users who may not wish to continue leasing equipment from ATTIS. Expanded competition in the residential CPE market makes it unnecessary for us to impose restrictions upon ATTIS in addition to those already encompassed in AT&T's plan.[1]

[1] See Procedures for Implementing the Detariffing of Customer Premises Equipment and Enhanced Services (Second Computer Inquiry), Report and Order, CC Docket No. 81-893, rel. December 15, 1983, at ¶ 77. (the *"CPE Implementation Order."*)

This represented a difference from business CPE products. Multiline CPE may have constituted two markets (equipment leased with bundled services, and sold equipment), whereas the residential market was unitary.

This recognition by the FCC was the very predicate for its drive to achieve a complete deregulation of the residential CPE market and was a basis for its decision being upheld by the Court of Appeals. In the FCC's view, only through such deregulation could the nascent competitive market for CPE fully develop, allowing consumers to pick and choose from among lease and retail options for CPE that were completely substitutable for their purposes. It should be noted that the correctness of the FCC's recognition that leased and sold residential CPE constituted a single market is borne out by the fact that since deregulation in the mid-1980s, fully 99 percent of leased phones have been replaced by purchased phones and other CPE.

C. 'Gold-Plated' Networks and `Bomb-Proof' Phones

Another facet of the environment present prior to deregulation—and which had to be addressed by federal and state regulators—was the very nature of the CPE leased to customers by AT&T. One hallmark of regulated communications industries is the tendency for regulated companies to engage in over-investment in their network plant and other assets. This has resulted, traditionally, in what is commonly known as "gold-plated" networks that absorb excessive capital—far

more than would be justified if costs were to be recovered, or returns on investment obtained, through competitive network operations.

Prior to deregulation, the Bell System was not exempt from such gold-plating with regard to the phones it produced and leased to its customers. These phones were over-engineered, endowed with hard plastic casings and designed to function through years of abuse far beyond what any communications device would normally encounter—hence the common industry term for them: "bomb-proof" phones.

There were two reasons for the Bell System's over-capitalization of its CPE manufacturing, one of them economic and the other both regulatory and practical. The first reason can be found in the nature of regulation itself. Since the Bell System was guaranteed to obtain a certain rate of return on its investment, a higher level of investment in CPE equipment quality would not only be easily recovered from the ratebase, it would generate a guaranteed high return on investment, thus improving the company's profitability as a whole. In essence, there was every monetary reason to sink capital into bomb-proof telephones and no risk for doing so.

The second reason for overbuilding CPE assets was to eliminate, as much as possible, the need for repairing them. The Bell System's leased phones were designed to operate for a long period of time without wearing out or requiring

replacement parts or maintenance. The reason for that can be found in the high cost of maintenance trips to repair such residential equipment. Technicians (often, two to a truck) would have to be dispatched to a single home, often in a remote rural area, spending large amounts of time and incurring massive labor costs. Meanwhile, in keeping with the policy-driven desire to keep low CPE rates, residential customers were charged only a nominal amount for repair visits—not anywhere near an amount that would actually cover the costs of such repair visits. Moreover, the sturdier and more over-engineered phones were, the less they malfunctioned, and therefore, the fewer complaints state regulators received about faulty or unreliable telephone service.

So we see that, in addition to the low rates customers paid for CPE, the phones themselves were artificial products of a regulated environment. No competitive CPE market would have produced costly, over-engineered telephones at any price, much less at artificial, below-market prices. Indeed, looking at CPE development around the world, we can see that Western Electric-type phones have largely disappeared now that CPE markets have been deregulated. The FCC had correctly recognized by the late 1970s that CPE manufacturing was the product of an artificial regulatory regime. It realized that in order to bring the greatest benefit to the public, what was needed was a complete dismantling of that artificial regulatory structure, which was preventing the development of a competitive residential CPE market. In other words, the FCC was convinced by that time that it should engage in aggressive moves to completely deregulate the

residential CPE market. Beginning in the late 1970s, and running through the mid-1980s, the FCC proceeded to do just that, and the subsequent results have been greeted with nearly universal approbation. In an industry rife with differences of opinion over regulatory issues, there is an astounding unanimity of opinion that the FCC's CPE deregulation was a success.

V. The Deregulation of CPE

A. The Full-Cost Ratemaking Approach

As stated in the previous section of this report, in order to establish the regulatory basis for a competitive residential CPE market—and for AT&T to fully and fairly compete, as well—the FCC had to do more than simply give companies an opportunity to offer CPE in competition with AT&T. It had to completely alter the environment in which the CPE market was to develop. That meant it had to dismantle the regulatory structure, so favored by the state regulators, that was foreclosing competition. That, in turn, meant addressing jurisdictional separations and cost allocations issues.

While CPE was included within the ratebase, the jurisdictional separations process assigned a significant percentage (about 25 percent) of the telephone instrument costs to the interstate jurisdiction for recovery through toll charges. Hence, any state-level CPE charges that recovered in excess of 75 percent of the instrument costs amounted to pure subsidy, which the state regulators used as a contribution to local and other intrastate services. It was generally accepted at the time that many rates were set at

between 75 percent and 100 percent in order to perpetuate this subsidy. It was necessary, then, to end this practice of using the jurisdictional separations process, through the excessive and destructive burdening of interstate long distance service, to subsidize local telecommunications services.

B. The Computer II Order

Because the FCC understood the need to achieve a radical restructuring of the market through deregulation, it decided in its first *Computer II* order to establish a flash-cut deregulation and removal of CPE from separations, on a date-certain: originally March 1, 1982.[2] As part of that decision, the FCC mandated a freeze in the price for existing equipment to be leased to customers. That freeze was to last for the "life of the equipment," which was not defined but which probably was designed to mean the depreciation life.

As soon as the FCC released its order, it drew criticism from nearly all affected parties that its decision to freeze the lease price was unreasonable and confiscatory and lacked legal justification. Critics noted that regulated companies have the right to have a fair chance to recover their costs. Traditionally, this was done by permitting a regulated company to "mark up" the price of a regulated service. If lease rates for existing equipment were to be held artificially low, however, that would generate problems regarding how AT&T's costs should be recovered. Additional legal issues were raised about the justification for freezing these rates, while claiming that CPE was in fact "deregulated." Moreover, the entire predicate for divestiture was that all

services transferred to AT&T were essentially competitive and were transitioning to full competition. As a practical matter, this foreclosed the possibility of marking up AT&T services to generate a subsidy. It would be difficult, after divestiture, for AT&T to raise rates for above-the-line ("regulated") services in order to subsidize low rates for CPE. While it is arguable that the FCC could have mandated this, as a practical matter, requiring ratepayers to subsidize a newly deregulated offering of CPE drew serious opposition. Moreover, under long-standing legal precedent, it was not clear whether the FCC had the proper legal foundation to direct a subsidy from above-the-line services to a below-the-line offering.

Despite these considerations, the FCC understood that a flash-cut approach might well lead to steep price increases and "rate shock" for both local service and CPE customers. This would place the FCC in a profoundly untenable political position and would draw criticism from state regulators, consumer groups and Congress.

C. The CPE Implementation Proceeding

Faced with this compound challenge of legal, practical and political difficulties, the FCC brought its CPE deregulation process to a screeching halt—if only temporarily. It initiated a new proceeding, the *CPE Implementation Proceeding*, to sort out the cost-allocation issues. Meanwhile, it defined all older, existing CPE, tariffed and separated as of January 1, 1983, as "embedded CPE," while all new CPE installed after that date was required to be excluded from the rate base and not tariffed.

[2] This date was later extended to January 1, 1983.

At this time, many state regulators argued for the ability to control some facets of deregulation or to otherwise continue regulating CPE, as a way to regulate the impact on consumers. The FCC, however, consistently maintained its exclusive authority over CPE deregulation and CPE itself, retaining its leadership in pursuing the conditions necessary for a truly competitive residential CPE market.

In the *Implementation Proceeding*, the FCC considered multiple options for shifting residential CPE to a deregulated environment, including terminating all CPE leasing or transferring all CPE to a third party or separate subsidiary. Two additional issues which had to be resolved were jurisdictional separations and the issue of valuation of the CPE assets.

In the midst of the proceeding, moreover, came the divestiture and break-up of the Bell System into constituent parts. This significantly altered the CPE deregulation picture by transferring the embedded CPE of the Bell System to AT&T, which was separated from the Bell regional holding companies. In effect, this made it easier to deregulate the residential CPE market, because AT&T's leasing business would be separated from the local service market power of the Bell operating companies. Moreover, the Bell companies could now be expected themselves to become competitive providers of CPE.

Divestiture introduced, however, a new concern on the part of the FCC and state regulators. They feared that the top-to-bottom, radical restructuring of the

telecommunications market would breed consumer confusion, chaos and disaffection. So regulators began looking for ways to minimize such consumer market shock, including in the FCC's plans for CPE deregulation—itself a major shift that would affect consumers, apart from the larger restructuring that divestiture represented. From now on, the minimization of consumer confusion would be a major element of decision-making as CPE deregulation proceeded. The FCC then began to work with AT&T to finalize a "voluntary" proposal to manage the transition to a deregulated CPE market, including the disposition of embedded CPE. It sought public comment on AT&T's proposals, which resulted in the formulation of the transition plan that resulted in the final deregulation of residential CPE.

E. Other Issues in Detariffing Embedded CPE

The FCC decided to work with AT&T and other parties, to develop a transition plan that could be implemented quickly and with less risk of a costly and time-consuming legal challenge. The plan was approved by the FCC, AT&T was required to comply with it, and AT&T, in fact, complied with it, as confirmed by subsequent close monitoring of AT&T's actions by the Commission. In the plan, the FCC set a 2-year transitional period for leased residential CPE. It explicitly rejected suggestions that a longer period of required rate ceilings be imposed in both the implementation order and on reconsideration. It should be emphasized, however, that this transition pricing plan, known as the "Price Protection Plan," did not establish prices according to what the FCC judged should be a proper level for AT&T's provision of CPE in a deregulated market. The FCC, at this point, was not interested in setting regulated

rates and standards to govern AT&T's power in the market, because it did not view AT&T as having any market power to restrain. Rather, the constraints put on AT&T in the transitional pricing plan had to do with the consumer-chaos issue and, to a lesser extent, the valuation issue. The FCC was sensitive to any action it might authorize that would further disrupt or confuse consumers already going through the break-up of the Bell System.

In formulating the plan to transition AT&T's embedded base equipment out of the regulated ratebase and allow true competition, the FCC had to deal with issues stemming from what was referred to as the Democratic Central Committee ("DCC") cases. According to the DCC doctrine, any losses or gains in the value of assets taken out of the regulated ratebase should be apportioned fairly among ratepayers and stockholders of the regulated company. That way, ratepayers and stockholders share in the benefits of successful shared business risk and assume a proportional part of the burden for unsuccessful risk.

In the case of embedded-base CPE, there was a tremendous amount of controversy over the valuation of the assets. The valuation was an important point of contention, because the higher the figure set for the embedded-base CPE, the more that ratepayers stood to benefit as the assets were taken out of the ratebase. That is, of course, because the higher the value calculated for an asset coming out of the rate base, the more the stockholders have to "pay" for it as the accounting transitions from above to below the line (i.e., the larger the asset value, the bigger the reduction to the ratebase).

In the case of the deregulation of CPE, then, there were two major issues—in addition to the core, primary issue of how to build a competitive market—in constructing a transition plan: (1) how to minimize residential customer confusion and chaos, and (2) how to set the valuation on the embedded-base residential CPE to comply with DCC as the assets transitioned below the line for accounting purposes.

To deal with the DCC valuation issue, the FCC set the valuation at net-book value, as a reasonable surrogate for a true valuation. AT&T argued that the net-book value was overstated for embedded CPE and offered no protection to AT&T if the value really was lower. But leaving aside the near impossibility of determining an appropriate valuation for the full inventory of embedded CPE, political pressure from state regulators, consumer groups and Congress prevented the FCC from reducing the local ratebase by any smaller amount. At the same time, because it was entirely possible that some of the equipment—including some residential equipment—had a higher value than net-book (or a higher-than-average value because of its age), the FCC decided to allow ratepayers to also capture that value by buying the equipment from AT&T at net book value plus the transaction price. In effect, this forced AT&T to sell the CPE at below its potential value. The purchase option for embedded CPE was always intended to be—and was explicitly made to be—temporary, because as long as it continued, it would be likely to undercut sales by competitive CPE providers, forestalling true CPE competition for residential customers. In fact, the FCC stated that the purchase option should go on only long enough to give consumers time to buy CPE and arrange for maintenance of it.

In addition, the price protection plan was adopted in part because state regulators had argued—and the FCC had reluctantly agreed—that there were pockets within the country where residential customers initially would not be universally able, in rural or economically disadvantaged areas, to purchase CPE. This gave rise to the conception of a so-called Upper Peninsula Person, who would not be able to readily access retail CPE outlets and would thus be unable to fully participate in, or benefit from, a competitive retail CPE market. Plus, the FCC was concerned that telling consumers they would have to either buy or give back their telephones would provoke a consumer backlash.

We can see, therefore, that the primary motivations driving the price protection plan were twofold: to minimize consumer confusion by requiring continued CPE leasing at interim rates, and preventing one of the two potential errors in valuation—essentially deciding to err, if at all, on the side of benefiting ratepayers. These were decidedly transitional concerns involving compliance with DCC and ensuring that ratepayers did not suffer from temporary dislocation or confusion. The policy driver was not a desire to restrain AT&T's behavior in the market over the long term, because the FCC felt that AT&T would not have any market power to abuse. Indeed, the Commission specifically found that "the competitive marketplace offers ready relief to those residential users who may not wish to continue leasing equipment from" AT&T.[3] AT&T would be simply another provider of unregulated CPE among

[3] *CPE Implementation Order*, ¶ 77.

many others—including the Bell regional holding companies from which AT&T had been separated. Indeed, the FCC recognized that increases in CPE prices from their artificially low, regulated levels were absolutely necessary for full competition to develop. For this reason, the FCC specifically and explicitly declined to impose any additional restrictions on AT&T—restrictions such as those suggested or called for by the plaintiffs and their experts.

As the FCC engaged in decision-making regarding the impact of deregulation on embedded-base customers, it kept in mind its conviction that full competition could develop only with complete deregulation, allowing prices to rise from their artificially low levels. But this goal was balanced by two short-term considerations. First, there was the need to ensure that the "Upper Peninsula person" would be able to obtain or retain a phone during the transition to competition. Second, there was the fact that on January 1, 1984, the telecommunications market in the United States changed completely with divestiture. The FCC recognized that increasing consumer confusion at such a time would not be in the public interest, even though in the long-term, full deregulation of residential CPE was necessary.

The FCC decided, therefore, to require the continuation of leasing with a "regulated" price for two years—a mandate that AT&T had not proposed. The FCC also required a $12 million to $18 million advertising campaign (developed by FCC staff), by AT&T to inform its residential embedded base customers of their options. In what

came to be known as the "modified negative option," AT&T was required to inform its customers in the following manner:

- Residential customers had to be told they had to make a choice between buying or continuing to lease their phones;
- AT&T could not make it easier to either lease or buy, thus tilting the balance one way or another in consumers' minds; and
- Consumers could not be told that if they failed to make a choice, they would continue to lease by default.

The FCC recognized, of course, that despite this mandated information campaign, some consumers would fail to enunciate their choices. For these individuals, the FCC had installed the Price Protection Plan, in essence, to save them from themselves. The Commission felt that it was precisely these people who would be most affected by the potential for disruption and confusion caused by the CPE deregulation, in combination with Divestiture. To the best of my recollection, not a single party objected to this treatment of those residential customers who failed to make a choice.

AT&T fully complied with the requirements to inform its customers through advertisements and billing inserts. As a result, a majority of residential consumers made informed choices regarding their embedded CPE. By the end of the two-year transition period, one would be hard-pressed to find consumers who did not know there was a competitive market to purchase residential CPE. In other words, the plan worked.

The FCC never saw a need to regulate AT&T's leased CPE rates or control them beyond the transition period. In fact, as noted above, it specifically rejected multiple requests by states and consumer groups for a longer period of price protection. The FCC clearly anticipated that AT&T would raise prices above the artificially depressed levels set during the era of regulation and continued during the transition period and modify services to offerings as required by the market. Indeed, when some parties objected to AT&T moving away from premises repair visits for residential CPE, the FCC noted that this conduct was not just permitted, but appropriate in a competitive marketplace. AT&T had to raise prices to market levels in order for a competitive CPE market to continue developing—which was the FCC's primary goal throughout the deregulation process. The FCC clearly anticipated this, and any observer of the process at the time should also have clearly anticipated it.

It is also important to keep in mind that the impetus for a mandated residential lease program came from the FCC and not from AT&T. The program was implemented because of concerns about customer confusion and, to some extent, valuation issues—not because of any perceived need to constrain market power. The AT&T proposal, as modified, made in Docket 81-893, was specifically and explicitly adopted by the Commission and AT&T was required to comply with the program. One of the requirements was that the materials provided to consumers soliciting a choice as to sale or lease be neutral. The specific materials were actually reviewed and approved by the FCC. It is these materials which are characterized as "misleading" by Ms. TerKuerst. In her report, she suggests a number of changes

which she believes AT&T should have made to these materials to avoid being misleading. Had AT&T adopted at least some of these "suggestions" of Ms. TerKuerst, it would have been in violation of the Commission's order and subject to substantial penalties, including in the extreme, criminal sanctions for willful disobedience.

VI. The FCC's Preemption of the States

A. The FCC Sought To Prevent Direct or Indirect Regulation of Embedded CPE

Throughout the period of CPE deregulation, the large majority of state regulatory agencies were still not in favor of introducing full competition. The FCC's actions were based on a specific finding that there would be large public benefits in deregulation. Securing those benefits required full deregulation, and any continuation of state regulation of this market would interfere with the achievement of this goal. In its *Computer II* and *CPE Implementation* proceedings, the FCC clearly established that the residential CPE market would be deregulated and would operate like a market for any other unregulated good or service. As stated above, this was the FCC's clear intent in painstakingly dismantling the structure of policies and rules that had kept CPE rates artificially low, foreclosing the possibility of competition. And this was the clear import of deregulating CPE and transferring the embedded base to AT&T, thus delinking it from any market power exercised by the Bell operating companies.

The FCC did not, of course, pre-empt all state laws and regulations that would apply to CPE. Such state regulations and laws could, however, only apply to AT&T as they applied to every other competitive provider of CPE. The FCC also made clear that any state attempt to impose any form of utility-like regulation of the provision of residential CPE—i.e., to apply rules based upon AT&T's inheritance of the embedded base or its prior or current "special" status—was prohibited, even if done through a facially neutral law or regulation. The FCC had some experience with states' applying "neutral" regulations in a way that would apply special treatment (see Commercial Communications, Inc. Petition for Declaratory Ruling, 81 F.C.C. 2d 106).

The FCC did, then, act to prevent and pre-empt any action by a state, local, or other federal authority that would apply special treatment to the residential CPE provided by AT&T as the inheritor of the embedded base. It preempted any state law, application of law, or other action which was predicated upon the "specific" nature of CPE, AT&T, or the embedded base, including attempts to regulate the form of notification of customers, the terms or conditions or the lease or sale option, or requirements for associated maintenance or the like. Thus, the FCC pre-empted any AT&T-specific regulations or rules applied to any defined "special groups" AT&T may have continued to serve, such as the elderly or disabled. In the FCC's view, there was a single market for residential CPE, and AT&T, de-coupled from the market power of the Bell operating companies, was not to be subject to specialized regulations because of its embedded-base leasing business beyond the transitional

period of the Price Protection Plan. By its actions, the FCC pre-empted any such specialized laws or regulations affecting this business. The FCC had long resisted state regulators' attempts to perpetuate and continue, long term, regulations that had focused on keeping the embedded-base prices low. The FCC specifically rejected those efforts, thus pre-empting state authority to implement them.

To try and explain the FCC's actions, it may be helpful to inquire whether conduct identical to AT&T's would be unlawful, actionable, or prohibited if it were undertaken by another entity, or by anyone selling or leasing toasters, or—perhaps, the best analog—cable modems. Any action that was predicated upon AT&T's "market power" in CPE subsequent to detariffing—or the fact that it "inherited" the embedded base—was both preempted and made unnecessary and inappropriate by the FCC's explicit determination that the market was fully competitive and that no such power existed.

Ms. Alexander, for example, notes that many states have passed consumer protection laws constraining long-term leases or "lease-for-sale." She accuses AT&T of "structuring its leasing program to avoid" these requirements and uses this as one basis for AT&T's liability. Of course, the states have chosen what conduct is inside the law and what conduct is outside their requirements, and every entity which leases anything month-to-month without a sale option could be accused of having "structured its program" to avoid these requirements. The "lease-for-sale" laws cannot, of course, be viewed as equivalent to a state prohibiting month-to-month

leasing. Therefore, the notion that, somehow, AT&T is somehow specially constrained as compared with others in structuring its leasing programs is precisely what was prohibited by the FCC's action.

B. The Plaintiffs' Experts Repeatedly Make Arguments Based on Flawed Rationales

Despite claims that AT&T's activities were illegal, unlawful, unconscionable, or otherwise actionable, they all rest on the assumption that AT&T enjoyed market power in a cognizable market, that AT&T should be subject to special or additional regulatory structures or requirements, or that both of these propositions are true. But these types of rationale are precisely what the FCC pre-empted in its proceedings deregulating CPE. The plaintiffs would not be presenting this case if the supplier were Radio Shack rather than AT&T, or if the products were televisions or even cable modems—perhaps the best analog to CPE.

The plaintiffs' experts argue that AT&T must have somehow violated its customers' rights because those customers—and/or this equipment—were somehow "special" or deserving of more strict regulatory protection than other customers using other equipment. This flies in the face of the FCC's proceedings and orders in which the Commission specifically sought to dismantle the mechanism by which the embedded base CPE were subject to specialized regulatory treatment. Thus, the impact of the Commission's actions is to pre-empt any state, local, or federal action re-imposing

such unwarranted special treatment of embedded-base residential CPE. The arguments for state action brought forward in this case are precisely what the FCC sought to preclude in creating a fully competitive, deregulated market.

The CPE deregulation process was, in my opinion—and in the nearly universal judgment of observers—an overwhelming success. In fact, it was the forerunner and model for CPE deregulation in many other parts of the world and was touted as such by FCC and other U.S. government officials in meetings around the globe. The FCC's preemption of any state and local laws or regulations that would perpetuate specialized treatment of the former embedded-base CPE was integral to the success of this effort and was expressly found to be so by the FCC. In my view, the relief sought by the plaintiffs in this case would violate the letter and spirit of the FCC's requirements and thus should not be granted by this court. Conversely, I believe that the actions and policies of AT&T, and later Lucent, were entirely compliant with the FCC's requirements, consistent with the FCC's deregulation goals and objectives, and wholly reasonable in a competitive market. Plaintiffs' experts essentially argue in favor of a continued regulation of embedded residential CPE, beginning in the transition period—at least in the case of some "deserving" customers. In part, I believe, this rests upon a misunderstanding of what was involved in CPE deregulation.

For example, one of the Plaintiff's experts, Ms. Alexander, concludes that AT&T acted unconscionably by comparing itself to actors in other "deregulated" industries.

She states that "[i]n most states, customers are being provided with service from their current utility provider at a capped or frozen price during a transition period, but the default provider is not allowed to market competitive programs to such customers and the default provider is being required to provide repeated and extensive consumer education materials and messages to such customers about the development of the competitive market and the role of the default provider in this market. Default services in these states will remain subject to state regulation for price and service quality for an indefinite period." She appears to confuse the "competition" (which, of course, existed long before January 1, 1984) with "deregulation." In no jurisdiction have residential local exchange services been deregulated. Moreover, in no jurisdiction, of which I am aware, have any local exchange providers been "not allowed to market competitive programs." She provides no examples or citations for these sweeping assertions of policy, and, in my opinion, they are blatantly incorrect and inapplicable with respect to any telephone services. CPE deregulation was a success, in large part, *because* of the actions which are cited here as the basis for assessing damages against the defendants.

In any event, while I strongly disagree with the plaintiffs' conclusion about the desirability or appropriateness of the type of continued "regulation" they champion—and whether it will have the effect of increasing or decreasing consumer welfare—the simple fact remains that such actions are precisely what were considered by the FCC and specifically rejected. Moreover, at any point, the plaintiffs, the plaintiffs' experts, or the consumer advocacy groups that they repeatedly cite (and with which

they are associated) were absolutely free to have petitioned the FCC to impose the requirements they now claim should have been applied. Indeed, they are even today free to go to the FCC and seek the re-regulation of some or all of the residential CPE marketplace. However, there is no doubt that much, if not all, of what is involved here is nothing but an attempt to raise these arguments in a different forum than the appropriate one.